

What Does Being on the “Watch List” Mean?

It is important that you understand what it means to be on the watch list and, perhaps more importantly, what it does not mean. Being on the watch list, as the name would imply, simply means we believe there is good reason to watch this fund more closely. Being on the watch list does not mean you should immediately sell your fund shares. It is not unusual for a fund to appear on the list from time to time. It does not mean the fund is necessarily a bad investment. If we believe the fund no longer represents a suitable investment option, we will remove the fund from the Plan.

Why Are Funds Placed on the Watch List?

Funds can be placed on the watch list for several reasons. Why a fund is on the watch list is more important than the mere fact it is on the watch list. The most typical reasons are as follows:

1. **Performance**—The most common reason a fund is placed on the watch list is poor performance relative to its appropriate market benchmark and/or peer group. When signs of relative underperformance appear, we place a fund on the watch list.
2. **Risk**—Less obvious to many participants is the risk that a fund manager incurs. If a fund becomes too volatile, we will place it on the watch list.
3. **Risk-Adjusted Returns**—What returns has the fund manager been able to deliver relative to the risk the fund has incurred? If the manager is unable to deliver adequate returns for the risk taken, we will place the fund on the watch list.
4. **Portfolio Construction/Style Drift**—Is the fund manager investing the money in the way he or she said he or she would? If you invest part of your assets in an aggressive fund that is supposed to be investing in the stock of small, growth-oriented companies, then you want the manager to do just that. We monitor the manager's portfolio, and if the security holdings do not reflect what has been communicated, we place the fund on the watch list.
5. **Operations**—There are many operational reasons for placing a fund on the watch list. First, the manager of the fund could leave. Remember, when you purchase shares of a mutual fund, what you are really doing is hiring a professional portfolio manager to invest your money. If that manager leaves, you should watch the fund closely.

Secondly, there could be firm-level issues. These can include issues such as regulatory violations, turnover in senior management, or a merger or acquisition. Any of these operational issues will automatically place a fund on the watch list.

Watch List

The State of Illinois Deferred Compensation Plan Current Watch List Summary

The following funds are on the watch list
as of 3/31/2007:

Ariel Fund underperformed for the quarter placing in the 58th percentile for its peer group. The fund has drifted out of the small value space and into the mid-cap blend category. The fund continues to lag dramatically for the longer term periods. The fund ranks in the 87th percentile for mid-cap blend funds over the one-year period that ended March 31, 2007. The fund returned 6.09% for that period versus 11.79% for the Russell Mid Cap Index. For those participants who bought this fund for small value exposure, the Plan has added a new small value option, the Northern Small Cap Value Fund. The State Board of Investment has removed Ariel from the state pension plan, but decided to keep Ariel in the deferred compensation plan for those participants who desire to invest in a minority owned Illinois-based firm.

Wells Fargo Advantage Large Company Growth Fund underperformed for the quarter with a loss of -0.50% versus the Russell 1000 Growth Index, which posted a 1.19% gain. The fund had shown signs of life last quarter, but has disappointed thus far this year. The fund is well positioned to take advantage of a market dominated by growth, with a high weighting to technology, and eventually the market will cycle in that direction. We are concerned that the fund does not seem to be able to put together two good quarters in a row. We will continue to monitor the situation.

Legg Mason Value Trust had bounced back in a big way in the fourth quarter returning 9.95%, but suffered this quarter with a loss of -1.42%. The fund had outperformed the S&P 500 15 straight calendar years, but it is in the 97th percentile for the one-year period ending March 31, 2007. This fund is highly concentrated and, therefore, volatile. For those wishing for a more stable large-cap blend option, there is the Vanguard Index Fund in the Plan. The fund will remain on the watch list until it puts a few good quarters together.

T. Rowe Price International Stock underperformed for the quarter posting a 2.50% gain versus the 4.15% gain posted by the international index, MSCI EAFE. The fund has bounced on and off the watch list, and T. Rowe Price has just announced that they will be changing the portfolio's manager in October. We will continue to monitor this fund closely.

Moving?

Deferred Compensation must be notified of any participant's address change. Please complete a Change Form, or you can mail or fax this information with your Social Security number and signature. You can now also e-mail the information.

If your change of address also affects any beneficiary, or if his or her address has changed, you should also complete a new Beneficiary Form.

Statement on Demand

Need a statement now for your financial institution? You may request a statement on demand through T. Rowe Price, the Plan's recordkeeper, anytime. You can either request it online at the myRetirementPlan Web site at rps.troweprice.com or call the Plan Account Line (PAL) at 1 888-457-5770, press or say "4," and you will be connected to the Plan literature request system.

Distribution Schedule

Distributions checks or direct deposits are sent on the Friday following the second Thursday of the month. This time schedule allows all accrual dividends to be posted to accounts before a distribution is made. Please allow four business days for checks that are mailed and two business days for direct deposits to be posted. A schedule of distribution dates is available through the Deferred Compensation Office.

Recordkeeping and Investment Structure Review

The contract for recordkeeping services with T. Rowe Price will expire on December 31, 2007. The Illinois State Board of Investment (ISBI) released a Request for Proposal (RFP) for recordkeeping services in February. As part of this process, ISBI is investigating the possibility of adopting a new investment platform, as introduced in last quarter's 457 News.

There are no anticipated changes to the fund option managers in the Plan at the current time. But as part of the search, respondents have been asked to submit proposals for both the existing platform, which provides only for mutual funds, and for a new structure that would also allow for separate account managers. The Board is now evaluating the proposals to see whether moving to a new structure offers cost advantages for participants.

Separately managed accounts are comparable to mutual funds, only they are not retail funds and are not sold to the public. With separately managed accounts, the assets are held by a single investor, which would be the State of Illinois Deferred Compensation Plan participants. As with a mutual fund, the assets are invested in a diversified group of stocks or bonds according to an investment mandate (stock, bond, small-cap, large-cap, growth, value, etc.). The fund option investment managers would be asked to shadow the current mutual funds in the Plan, thereby providing similar returns and performance as the actual mutual fund.

The benefits of separately managed accounts are derived from a savings to participants in lower investment management fees. These accounts do not allow participants to seek information or daily prices from independent third-party investment publications such as a newspaper. Separately managed accounts must be valued or "unitized" by a custodian to the recordkeeper, which will then make the information available to participants online. In addition, all the fund information must be developed and produced by the Plan. The INVESCO Stable Return Fund is an example of a separate account, but contrary to the Stable Return Fund, the potential new funds would fluctuate in value.



Portability

When eligible for a distribution, portability allows for the rollover of your Deferred Compensation Plan assets between other retirement savings plans such as a 401(k), 403(b), or an individual retirement account (IRA). Likewise, other plan assets from your previous employer may be eligible to be transferred into the Deferred Compensation Plan. The provision allows employees to liquidate and transfer money into a new employer's retirement plan when changing jobs or consolidating assets when leaving the workforce. The assets transferred into another plan will take on the characteristics of the receiving plan. This means that any Deferred Compensation money rolled out into an IRA may have the age 59½ restriction or 10% penalty for early withdrawal applied.

Along those lines, assets transferred into a 457 plan must retain the characteristics of the plan from which they were transferred. So the age restrictions on distribution from an IRA must remain with money rolled into Deferred Compensation. The assets are accounted for separately, but would appear as one account to the participant. The forms necessary to perform a rollover out of or into the Deferred Compensation Plan can be found at CMS's Web site at www.state.il.us/cms/employee/defcom.

Permissive Service Credits Purchase

Did you know participants have the option of purchasing creditable service with any Illinois Retirement System using their Deferred Compensation assets on a pretax basis? This service time may include a new employee probationary period, military time, previous service credits that were cashed out, or service credits with a reciprocal retirement system.

In order to purchase this time, a participant must obtain a cost estimate from the appropriate retirement system; complete a Permissive Service Authorization Form from the Deferred Compensation Office and submit both forms to the office a month prior to the intended purchase of service credits. In order to take advantage of this provision, the entire amount of the purchase must be made in one transfer from your account. You can find this form along with others on the CMS Web site at www.state.il.us/cms/employee/defcom.

Online Statements

A Better Way to Organize Your Financial Documents

Your statements are valuable documents, yet keeping them safe and organized can be a challenge. That's why they're made available online!

The new online features make it easy and convenient for you to:

- ◆ Get your statement information wherever there's Internet access.
- ◆ See your statements as soon as they're ready, without having to wait for the mail.
- ◆ Control clutter with online filing and storage up to seven years, including requested Statements on Demand.

You'll still be getting your hard-copy versions mailed to you, but you're sure to enjoy the convenience of getting your statements online. Visit **myRetirementPlan** Web site today at rps.troweprice.com to view your most recent quarterly statement. Simply click on the "Services" tab in the online screen and choose Online Statements. If you register your e-mail address, you will be notified when the next statement is ready for you to review. If you have not yet signed up for account access, you can do so by calling 1-800-541-3020.

How do I...? Where do I find...?

If you have access to online capabilities, you can find most of the tools you need to access your account or make changes to your personal elections and information. Depending on what you need, there are two Web sites to make sure you can find what you're looking for, at your convenience.

Your Account Balance and More

You can access your account value and investment information at the recordkeeper's Web site at rps.troweprice.com. The T. Rowe Price homepage is organized for easy navigation, including tabs across the top of the screen based on your needs; a full Portfolio Summary, Risk Return Analysis from Morningstar Plan Services, a portfolio "Instant X-Ray" from Morningstar, the Message Board, Power Tools, Quarterly Market Update Video and podcast, market information, news, and links to publications. Plus, you can find any of the latest news about the Plan listed on this page in the Message Board and News and Publications.

This site provides many of the same services the voice response unit and the telephone representatives provide. You can view your account balance by investment, transaction details, your investment election allocation, and perform investment transaction exchanges. If you have not yet signed up for account access, you can do so by calling 1-800-541-3020.

Your Plan Information and Elections

You can go to the State's Web site to get Plan information and the forms necessary to make any of the changes. At www.state.il.us/cms/employee/defcom, you can scroll down the page to find the latest news on the Plan plus headings that will allow you to get details on your specific needs. These headings include FAQs, fund descriptions, prices and performance, forms and newsletters, the plan booklet, and a section on distribution basics.

Do you want to change your deferral amount? No problem, simply print the Change Form and send it to your Agency Liaison or the address listed for the Deferred Compensation Office. Do you want more information on the investment options? Click on the fund description section and learn about their risk profile or download a prospectus. Want to read more about the rules and how the Plan operates? Check out the Building for Your Financial Future Booklet. If you are getting ready to retire, there is a distribution section dedicated to items to consider when choosing how you may want to withdraw your account.

If you do not have access to a computer with online capabilities, you can always call the Deferred Compensation Office at 1-800-442-1300, option #3, or 217-782-7006, and TDD/TYY 1-800-526-0844. For any investment option changes, call T. Rowe Price at 1-888-457-5770.

Telephone Numbers

Deferred Compensation:

Plan Rules/Options Information

800-442-1300

217-782-7006

TDD/TTY: 800-526-0844

Internet: www.state.il.us/cms/employee/defcom

Recordkeeper:

T. Rowe Price Retirement Plan Services, Inc.

Account Value Information and

Investment Changes: 888-457-5770 or

TDD/TTY: 800-521-0325

Internet Access: 800-541-3022

Internet: rps.troweprice.com

